Ethiopia Country Dialogue
August 28-30, 2004

I. Country Background

Ethiopia is home to one of the world's oldest civilizations. Its former imperial family, who claimed to be descendents of Solomon and Sheba, were overthrown in 1974. Under the Derg regime that came to power around then until its ouster in 1991, the country experienced political turmoil, repression and economic mismanagement, amidst an intensifying civil war and the periodic tragedy of large-scale deaths from famines. In 1991, when the civil war ended, Ethiopia had just about the lowest per capita income in the world. Relatedly, its social indicators and infrastructural network were amongst the worst with, for example, educational enrollments, health status and access to roads being so far below the averages for Sub-Saharan Africa that they remain so, despite programs to improve them that rank amongst the most ambitious in the Region in the past decade or so.

Since 1991, Ethiopia's economy has experienced a remarkable degree of macroeconomic stability and pretty good growth on average, despite the 1998-2000 conflict with Eritrea. Since 1992, average annual inflation has been in the low single digits and GDP growth has averaged around 6 percent a year. However, growth has been highly variable reflecting the dependence of the economy on a rain-fed agricultural sector subject to capricious weather. The prices of Ethiopia's primary export, coffee, have been on a declining trend and so have its terms of trade, especially in recent years with the terms of trade declining by some 40 percent between FY00 and FY03 with the collapse of coffee prices. The drought of 2001/2002 (which straddled the FYs 2002/03) was the most severe since the one in 1984/5. Whilst there was widespread hunger and many people died, a famine on the scale that Ethiopia has endured in the 1970s and the 1980s was avoided.

II. Country Dialogue

As part of its program of Country Dialogues, the Initiative for Policy Dialogue (IPD) organized a visit to Ethiopia in August 2004, in partnership with the Ethiopia Development Research Institute (EDRI) and the Inter-Africa Group (IAG). UNDP provided financial support. The IPD team comprised Joseph Stiglitz , Akbar Noman and Laura Limonic (all from IPD/Columbia University) and Robert Wade (LSE).

The team traveled to Ethiopia with the objective of engaging in a discussion of economic policy options with the Government, academics, private sector, other civil society stakeholders and the donor community. The aim was also to promote a dialogue amongst these groups. In addition to Prime Minister Meles Zenawi and other senior policy makers, the IPD team held a series of meetings with representatives of the private sector, academics, political parties and donors culminating in a public dialogue attended by a diverse audience of some 400-500 persons. A similar audience attended a set of two public lectures by Prof. Stiglitz and Prof. Wade, respectively.

Overall, then the dialogue would have served to facilitate and improve communications between the government and civil society, including notably the private sector, but also politicians and academics. Regarding the broadening the debate and illuminating economic policy options and trade-offs, probably the most significant impact of the dialogue would have been with respect to: the appropriate strategic role of the state; the potential and pitfalls of industrial policy; export promotion as part of a broader agenda of facilitating an efficient, competitive industrial sector; enhancing the role of the financial sector in lubricating development; and agricultural price policy.

The more specific highlights of the rich, wide-ranging discussions are summarized below under the headings of the major themes of the dialogue.

III. Overall Development Strategy

There was considerable interest in two sets of broad strategic considerations. One revolved around the role of the state, in particular the contrast between on the one hand, the "minimalist" role of the state in a version of what have been labeled as the "Washington Consensus" policies and on the other, the "developmental state" that is seen as central to East Asian success. The IPD team noted that this should not be interpreted as a market vs. non-market issue. Markets are vital but imperfect and the question is to identify what the important market failures are in any particular context and what can be done to correct them. Also the issue is not one of the size of the state but of its appropriate role.

Whilst one must be mindful of the failures of governmental interventions and the dangers of rent-seeking, there is little doubt that governments can promote sustainable and equitable development. The developmental state was highly successful in East Asia. But there is a need to be wary of a simple, straightforward imitation of East Asian policies: one has to ask whether and in what way the policy lessons can be derived and applied in the different context of Ethiopia and the global economy today. What the East Asian examples clearly demonstrate is that the state can fortify the "invisible hand" of the market with great success, especially in the quest for dynamic comparative advantage and technological upgrading as well as protecting the economy from the risks and vulnerabilities that unfettered markets can sometimes impose such as those that can result from capital market liberalization.

The other set of strategic issues revolved around the Ethiopian governments' strategy of "Agricultural Development Led Industrialization" (ADLI). On one view ADLI has led to an excessive focus on agriculture at the expense of industry whilst the two should be seen as complementary. Whether or to what extent there has been such a bias in Ethiopia in the past, there seems to be a consensus that agriculture and industry should be seen as complements rather than substitutes, that “agricultural-development-led” is an adjective in ADLI whilst “industrialization” is the noun. What ADLI is interpreted as emphasizing is the importance of not neglecting agriculture not only for industrialization in the Ethiopian context but also for a development strategy that aims to ensure that the benefits of development are widely shared so that growth is pro-poor. The IPD team agreed with the renewed emphasis on promoting broad-based development of SMEs in dispersed urban centers, including small towns, as an element of ADLI.

IV. Agriculture

There is no gainsaying the importance of agriculture, which accounts for close to half of GDP and employs about three-quarter of the labor force. There is very little irrigation. Despite considerable attention to the sector, agricultural yields have on average stagnated as increasing yields on long-settled lands on account of rising use of fertilizer and other inputs have been offset by the lower yields on more marginal land brought under new cultivation. In the long-run, major irrigation works hold the promise of liberating Ethiopia from the dependence on its highly capricious rainfall and hence from the high variability in outputs and prices. But for quite some time, Ethiopia has to contend with the problem of years of good rainfall with falling producer prices and of bad years with falling quantities and rising prices. This reflects the nexus of poor roads and agricultural markets that makes transport costs extremely high and makes many crops “non-tradables” in effect. The extraordinarily high riskiness of farming in Ethiopia mitigates against the adoption of modern inputs and technologies. Thus, for example, a farmer is constrained from using credit to buy fertilizer, even where such credit is available, by the risk of either a collapse in production or prices rendering her unable to repay. This, in turn keeps the farmer locked in a low-yield agriculture.

There is a great deal of interest in Ethiopia in trying to help the farmer to break out of this vicious circle by stabilizing prices. Partly it is matter of improving the functioning of markets and lowering transport costs, especially by improving the road network. But there is also a potential role for price stabilization schemes if such schemes can be properly designed and implemented. This is a considerable challenge given the history of failures of government interventions of this sort but there are also some examples of success. Given the importance of food aid in Ethiopia, improvements in how donors make that aid available, could also help to alleviate the price variability problem. This matter deserves further careful study.

One highly charged issue in Ethiopia is that of land tenure. The constitution bars private ownership. While all sides in the debate recognize the importance of security of tenure, some of the opposition political parties and elements of the private sector and academic community hold the view that full-fledged private ownership is essential for agricultural progress. The other view, to which the government subscribes, is that there are other ways of ensuring security of tenure and incentives to invest in the land, whilst unrestricted ownership rights run the risk of distress sales by peasants in the frequent years of crop failures in Ethiopia and the creation of a large class of landless peasants. Leasing of land along with rights of use and inheritance will achieve the necessary incentives and prevent rising inequality and landlessness. The IPD team noted that other countries have achieved rapid agricultural and rural growth without full ownership, notably China and also Vietnam. What is important is credible security of land rights and that there can be a conflict between full-fledged ownership and egalitarian growth, especially in a context such as that of Ethiopia where there is a real danger of distress sales in bad years.

The IPD team's discussion also covered the issues of improving productivity, rural credit, markets and infrastructure (especially roads and irrigation) as well as improving the incentives for farmers to move to areas of relative land abundance and agricultural potential, in particular by eradication of malaria that is so common in these areas.

There is considerable scope for raising yields by increasing fertilizer use. Fertilizer, however, is risky, since it will only yield higher productivity if there is rain. Without rain, the farmer will be forced to repay for the fertilizer without the extra-added income and will go into debt. While there is an agricultural extension scheme, many argue that it needs reform, in particular by separating extension functions from those of provision of credit and fertilizer. The farmers need to pre-order the quantity and mix of fertilizer; which dampened demand and yield response. In the long run the government plans on having cooperatives, which should alleviate the problem of access to fertilizer. There needs to be a functioning input market that depends on a functioning credit market. Output markets also need to be able to absorb surplus. Farmers also need to have improved access to input markets. There has been some recent discussion on creating input and marketing cooperative to meet the needs of the small farmer. It was pointed out that agricultural cooperatives have played an important role in some parts of the world. The Land-o-Lakes cooperative is an example of an important one in the U.S.

The role of food aid was also discussed and the IPD team welcomed the EU decision to shift increasingly to food aid in the form of cash rather than commodities as this would help to prevent the destabilizing effect of food aid on domestic markets and prices. Food aid in this from can be used to buy food in the domestic market in surplus years/regions for use in deficit years/regions.

Whilst, there has been great progress in providing credit to farmers, the institutional arrangements have tended to dampen the efficacy of agricultural credit markets with a large role for extension agents and Regional governments, There is increasing attention being paid to divorcing extension from credit, to strengthening micro-credit institutions and security for credit, including the possibility of using crops as collateral.

V. Industry and the Private Sector

The formal or organized private sector in Ethiopia has been recovering from its decimation under the Derg regime but remains both weak and in an uneasy or ambivalent relationship with the government. The relationship between one important segment of the private sector and the government seems to be so heavily influenced by a political divide that it is difficult to disentangle differences on policies from political or ideological disputes. Whilst there are other segments of the private sector whose relationship with the government is not dominated by political rivalries, private sector development would be facilitated by the establishment of a *modus vivendi* between the other segment and the government based on strengthening of mutual trust and dialogue. This is essentially a delicate political task to which an institution like the IPD can only contribute, in as much as it can help to improve communications and understanding of policy options and that in turn facilitates a better understanding on the relative roles and responsibilities of the private and public sectors.

One issue that came up in the discussion is that of the relationship between anti-corruption actions and private sector development. One private sector view was that the governments' actions in imprisoning some bankers and businessmen for corrupt practices had adversely affected private sector confidence and the flow of credit (as bankers became excessively cautious in lending). The governments' stated position is that it wishes to encourage legitimate private sector activity but will aim to crackdown on corruption and rent-seeking activities, The IPD team emphasized the importance of fighting corruption and of doing so in a transparent manner and with access to adequate and speedy judicial redress.

There have also been significant improvements in the business environment in Ethiopia in the past 2-3 years and this seems to be widely recognized by the private sector. Regulatory/licensing impediments to doing business have been eased considerably and a particularly heartening feature has been the t way export promotion policies have been improved and begun to have an impact. Non-traditional exports are beginning to show encouraging signs of responding with horticulture exports being a notable example. Access to credit and reducing transaction costs have been vital elements of export promotion. The IPD team emphasized the importance of a generalized, across-the-board reduction in transaction costs and improvements in access to credit.

The East Asian experience suggests that the difference between export promotion and import replacement can be exaggerated and they can be complementary. Some industries started out producing for the domestic market before entering foreign markets. At any rate, attention to exports should not mean neglect of other opportunities for developing an efficient and competitive manufacturing sector.

In this context, there was considerable discussion of industrial policies and the role they played in East Asia. Promotion of exports does provide an objective yardstick for competitiveness and makes it easier to dampen rent seeking. It makes sense to initially focus industrial policy on exports. Clearly, the East Asian example demonstrates that industrial policies can work well but policy makers also need to be mindful of the dangers of "picking losers" and promoting rent seeking.

There was considerable discussion of the details of the design of industrial policies in East Asia, particularly Japan. Korea and Taiwan, and how important the attention to detail was. Success is not facile and could be facilitated by having a framework in place to better understand the needs of each industry and better implement policies that will bolster the competitiveness of the industries. Business association can be a powerful tool in helping the government to define what the right government policies should be. The role of the state should be seen not so much as picking winners as correcting market failures that impede the realization of dynamic comparative advantage and emergence of an efficient, competitive industrial sector engaged in learning and technological upgrading.

An issue of some contention in Ethiopia is that of the role of businesses affiliated with political parties. Some representatives of the private sector feel that these businesses have an unfair advantage whilst the governments' stated aim is to avoid tilting the playing field such that the rest of the private sector is harmed and that given the weakness of the private/business/entrepreneurial class these party affiliated businesses have a role to play in accelerating development as they did in some East Asian economies, notably Taiwan and China.

VI. Financial Sector

The weaknesses of the financial sector are an important constraint to rapid industrialization in Ethiopia. The banking system is characterized by substantial excess liquidity with the state-owned banks, especially the biggest bank, the Commercial Bank of Ethiopia (CBE), having the most excess liquidity. At the same time, the private sector feels credit constrained. The limited availability of term credit is a particular constraint.

A variety of options for easing the credit constraint were discussed. These included informal guidance to banks, especially the state-owned ones; taxing excess reserves; strengthening the capacity of banks to appraise loan applications and of the private sector to prepare bankable projects; cleaning up the balance sheets of banks by taking care of non-performing loans along with measures to prevent their recurrence; broadening the scope of the credit scheme recently introduced to assist exporters, including by a more general fortification of development finance institutions (DFIs).

> There was considerable interest in and discussion of the pros and cons of interventions in credit markets of the East Asian variety. Directed credit can be an important instrument of industrial policy and the issue in large part comes down to the case for industrial policy and the pre-requisites for its success. Learning from the examples and experiences not only of East Asia but other DFIs such as BNDES, the Brazilian development bank, was an option for Ethiopia to consider.

VI. Infrastructure

The state of physical infrastructure in Ethiopia is a serious hindrance to development with indicators such as those for density of road network, access to electricity and water, telephone and internet access all worse that the averages for Sub-Saharan Africa. The government's ambitious program for expansion and improvement of roads is laudable and this has to be essentially a public sector responsibility. This is vital for lowering the very high transportation costs and development of markets, especially in rural areas.

As far as electricity is concerned, the government has opened generation to the private sector but not the natural monopolies of transmission and distribution. However, the response of the private sector has been limited. The most contentious issues surround the policy on telecommunications. Here, there is a state-owned monopoly, the Ethiopian Telecommunications Corporation (ETC) and some halting liberalization has been confined to allowing joint ventures with ETC in some areas such as cellular phones. There has been virtually no interest from either foreign or domestic investors in such joint ventures. There is a strong and widely-held view amongst the private sector and donors that the government needs to liberalize the telecoms sector quite a bit more.

The government, on the other hand, remains concerned about inadequate attention to rural areas, the possible loss of revenue by not being able to recoup in taxes the lower profitability of ETC and feels that the constraint is primarily one of lack of skills rather than finance. They plan to continue to invest in the telecom sector, especially in a microwave network, a broadband network and provide access to all villages. The government has put out a bid for the mobile telecom industry and will ask the foreign firm to provide hardware and implementation. Once that is in place they plan to liberalize the sector, beginning with small domestic investors. The mobile market in Ethiopia is new with 150,000 new subscribers in the last 2-3 years.

The IPD team proposed that the a way to increase supply, lower prices and ensure wide-spread access is to have the right regularity environment, the right mix of policies and eventually open up markets. Korea is an example where they were able to gradually open up the telecom sector first to domestic firms and later to joint ventures with foreign firms. This process put the Korean telecom industry in a powerful position. The Korean experience shows how a phased liberalization is a tool in placing an industry in a competitive and efficient environment. The fact remains that providing low cost telecom is an important step in development. Farmers, for example, can more easily get commodity pries if there is a working telecom sector. Ethiopia needs to explore ways to accelerate the liberalization of the telecoms sector.

VII. Aid and Scaling-up

In the meeting with representatives of the donor community, the issues discussed included those pertaining to increasing the effectiveness of foreign assistance. The IPD team strongly welcomed the shift in assistance from project to program aid that some donors were undertaking and on which they sought the views of the IPD team. The form in which food aid was provided was also discussed with a focus on how to use food aid to help rather than hinder sustainable increases in domestic food production, including by using food aid in cash rather than commodity form to purchase food locally in surplus years and regions for use in deficit years and regions. This would serve to dampen the very high volatility of prices, especially the collapse of prices when the rainfall was good. On the issue of the role of NGOs, the IPD team shared the view that whilst NGOs were particularly effective in innovation and experimentation, they often faced difficulties in scaling-up activities to have a wider, national impact and hence could not substitute for governmental programs. What was needed were appropriate partnerships between the NGOs and government rather than substitution of governmental activities by NGOs.